Comments on Merger Enforcement

Submitted by
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Submitted by E-mail to
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Antitrust Modernization Commission (AMC)
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Attn: Public Comments
Antitrust Modernization Commission

Dear Sirs,

I submit these comments as president of my company, Relpromax Antitrust, Inc. I am an economist, not an attorney. I respond only to selected questions.

I object to the deletion of E-mail addresses, both mine and others, from submitted comments. Such deletion impedes communication among comment submitters, and is also a form of censorship. It is objectionable on First Amendment grounds. If any of us did not want our E-mail addresses publicized, we could have easily removed them before submitting comments.

Thank you for your consideration.

Sincerely,

Carl Lundgren
Economist and President
Relpromax Antitrust, Inc.

A. *Federal Antitrust Merger Enforcement Policy Generally*

1. Has current U.S. merger enforcement policy been effective in ensuring competitively operating markets without unduly hampering the ability of companies to operate efficiently and compete in global markets? Please identify specific examples, evidence, or analyses supporting your assessment.

Under the merger laws, the choices for the antitrust authorities are: 1) approve the merger, 2) disapprove the merger, or 3) approve the merger with conditions. One well-known condition is divestiture of assets in selected markets, to avoid a reduction in competition.

Relevance of the RPM Incentives Method to Merger Enforcement

Another possible condition for merger could be a requirement that the merging firms use relative profit maximizing (RPM) incentives. Such implementation of the RPM method would attenuate possible incentives for collusion between the merging firms and the remaining firms in the market. Implementation of RPM incentives can be a useful condition of merger, if a merger would otherwise be illegal under the antitrust laws.

Such use of RPM incentives, solely as a condition for merger, would be only a partial implementation of the RPM method. Such partial implementation of RPM incentives is less beneficial to consumers than a complete RPM implementation.

RPM incentives are a new economic method for preventing oligopoly collusion and other forms of imperfect competition by oligopolies. The method can be applied either to the managers of business firms or to business firms as a whole. When applied to managers, the method eliminates incentives for collusion by making managerial compensation depend on relative profits rather than absolute profits. Relative profits are defined as profits of the firm relative to the profits of rival firms within the same market or industry. Absolute profits are simply profits as ordinarily defined.

In its most complete implementation, the RPM method sets up a zero-sum game among the firms in an industry, yielding the result that firms no longer have incentive to collude, either actually or tacitly, with regard to prices or outputs. In a zero-sum game, one firm can gain profit only if another firm loses profit; hence there is no longer an incentive for every firm to collude. (See Lundgren for a more detailed explanation.)

Antitrust law forbids mergers that substantially increase market concentration, but this policy is limited because it does not forbid or remedy an oligopoly market that is already too concentrated. Even though collusion is forbidden, oligopolies can often coordinate tacitly with little or no fear of being penalized. Even without collusion, oligopolies can be imperfectly competitive in other ways. One structural approach is divestiture: Break up the largest firm(s) into smaller firms. Another approach is to use relative profit maximizing (RPM) incentives to induce pro-competitive outcomes in oligopoly industries. These two approaches are not incompatible. They can be implemented simultaneously.

The antitrust laws should be revised to allow complete implementation of the RPM method so that consumers can benefit fully from this economic innovation. The AMC should recommend broad use of the RPM method, both in concentrated oligopoly industries and for monopolies that should be broken up.

AAI's Response to This Question

The American Antitrust Institute (AAI) also responded to this question. Except for their failure to discuss RPM incentives, I am in sympathy with virtually everything they said. For purposes of this answer, I quote and extend portions of their response.

> However, the agencies have in general been reluctant to challenge mergers from 5 to 4 (or even 4 to 3) significant competitors in the markets. Some of these mergers have presented competitive problems according to the AAI. In other instances the agencies have attempted to challenge arguably 3 to 2 mergers, but the courts have nevertheless permitted the merger. It appears that enforcement policy has evolved to the point where 2 to 1 or 3 to 2 mergers are the only ones that the agencies will regularly consider dangerous to competition. The move to challenging only mergers with very high concentration levels can be clearly seen in Federal Trade Commission and U.S. Department of Justice, Merger Challenges Data, Fiscal Years 1999-2003, December 18, 2003.
>
> This evolution appears to reflect an informal policy determination that concentration short of these high levels and changes is seldom worthy of challenge. This de facto policy raises the critical question of justification for the change. Is this evolution based on empirical evidence, or has policy strayed from the evidence and reflects other considerations and preferences? (pp. 2-3, footnotes omitted)
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> The consensus conclusion from more recent studies using more sophisticated research tools is that increased concentration, at high levels, is associated with higher prices, and is therefore a suitable proxy, at least in the first instance, for an expectation of market power. In particular, as an empirical matter, high seller concentration in a properly defined market with significant barriers to entry is associated with higher prices, all other things being equal, and increases in concentration, particularly substantial ones in markets that are already highly concentrated, may precipitate large price increases. (p. 14)
>
> With respect to potential coordinated effects, heightened concern has historically arisen around the point at which there will no longer be at least five strong competitors or when a dominant firm may enhance its price leadership role through a merger. We see no reason to revise this general benchmark at this time. (p. 17)
>
> With respect to unilateral effects, heightened concern has historically arisen around the point at which the leading firm's market share is at least 35%. We see no reason to change this benchmark level at this time. (p. 17)

From these quotes, it appears that the antitrust agencies are failing to combat important parts of the oligopoly problem using the tools they already have available. This could indicate inability or unwillingness of the agencies to fully represent the public interest, particularly consumer interests, as opposed to business interests. Because the enforcement of merger policy is apparently discretionary, the agencies are derelict. If the agencies are not being derelict, they should perhaps explain themselves better.

By contrast, the Congress could require the implementation of RPM incentives in all markets or industries meeting pre-set criteria. Such criteria might include firm size and market shares of firms, as well as HHI measures. For example, Congress might require RPM incentives for all firms with a market valuation in excess of $1 billion and a market share in excess of 10%, in any market with an HHI greater than 1000 (or 1800). RPM incentives can also be used to combat unilateral effects, for example, by requiring their use by firms with market share greater than 35%.

The imposition of RPM incentives would have little deleterious effect, even if they were applied to industries that would otherwise be competitive. Their primary effect is to assure that the industries to which they are applied remain competitive. Hence, RPM incentives can be applied to the vast majority of industries meeting pre-set criteria, even in industries where there is only a small likelihood of anti-competitive behavior occurring. Congress can take care of the competition problem using more efficient and effective tools than the current cops-and-robbers approach.

The AMC should not be derelict in its duty to consider this important alternative.

B. *Transparency in Federal Agency Merger Review*

1. Several commenters in the first phase of the Commission's work advised that the Commission should address whether there is sufficient transparency in federal antitrust enforcement policy. Do the *Horizontal Merger Guidelines* provide informative guidance to merging parties regarding the likely antitrust treatment of their transactions, and do they appear accurately to reflect actual current FTC and DOJ enforcement practices (for example, with respect to market definition and concentration threshold presumptions of antitrust concern)?

The issue of transparency in antitrust goes far beyond the adequacy of the *Horizontal Merger Guidelines* to reflect actual current FTC and DOJ enforcement practices. There are two broader antitrust issues: Transparency of government and transparency of business.

Transparency of Government

The government should provide transparency in its economic modeling and analysis of antitrust cases.

The government should be required to divulge its economic models, analysis, and supporting data for antitrust cases, including cases that are not brought to trial (e.g., merger reviews). Transparency in government action is a democratic norm that helps to keep government accountable. The lack of disclosure harms the ability of the public to understand what the government is doing and how the government reasons. It also prevents outside parties from suggesting alternatives or improvements to the government's reasoning and proposed remedies.

The lack of transparency is evident even in Tunney Act settlements and fully tried cases. For example, one will look in vain for a good economic model of the PC operating system industry based on the Microsoft case. The claims by business for confidentiality of basic economic information are often overblown, as the Judge in the Oracle merger case noted.

As shown by the Microsoft Tunney Act settlement, the Tunney Act has become a farce. Appeals courts have diluted the Tunney Act and converted all district judges into rubber stamps who must ignore evidence of apparent corruption and who must avoid any genuine inquiry into whether an antitrust settlement truly meets antitrust goals. The Tunney Act disclosure requirements and public interest tests must be strengthened.

Substantially more information disclosure and economic analysis is required when the Executive Branch promulgates or rescinds any government regulation (Executive Order 12866). Why is there no similar disclosure of information and analysis in antitrust cases?

Transparency of Business

The government should collect cost, revenue, and profit data for lines of business in large firms.

Information about which lines of business are profitable or unprofitable is necessary for the correct allocation of capital. This information is often obscured when large businesses with several products or services combine their accounting information across broad categories. If potential competitors do not know which lines of business are most profitable, sufficient entry is not attracted. If potential competitors do not know which lines of business are least profitable, too much entry may be attracted into unprofitable endeavors. In any event, the uncertainty created by obscured information increases the risk for all business entry, thus ensuring less competition overall.

The secrecy of economic data is not needed to protect innovation. Mere cost or revenue data, by itself, does not disclose trade secrets concerning the nature of any innovation which might produce such data. Hence, this type of secrecy is not needed to provide incentives for innovation.

Public disclosure of such economic data, conceivably, might aid actual or tacit collusive agreements, but only if the disclosures occurred fairly immediately. Hence, the government might reasonably impose a delay before public release of such economic information. For example, such delay might be on the order of three years. Researchers who wished to analyze the data even sooner could sign confidentiality agreements.

I believe the FTC had a program in the 1970s to require such data, but the program lasted only five years, presumably because of business opposition. Such data would be useful to economists, legislators, and others who wish to analyze or estimate the extent of the antitrust problem and the usefulness of various possible correctives. Such data and analysis can only contribute to economic knowledge and perhaps lead to better economic policies.

C. *Efficiencies in Merger Analysis*

2. (a) What types of efficiencies should be recognized in antitrust merger analysis and in what circumstances should they be considered or not considered in determining the legality of a merger?

This question is answerable if one knows the goal of antitrust. In answer to question 3 below I indicate that equitable distribution (relative to what a competitive market would provide) is the proper goal. For most mergers, seller power rather than buyer power (i.e., monopoly rather than monopsony) is the primary concern. In such cases, the proper question is whether consumers in the affected markets (not the economy as a whole) benefit (or at least are not harmed) from a merger. If the production efficiencies of the merger are insufficient to prevent likely harm to consumers in the affected market, then the merger is not acceptable.

3. What is the appropriate welfare standard to use in assessing efficiencies — a consumer welfare standard, a total welfare standard, or some alternative standard?

Summary of answer: The appropriate standard is an alternative standard that emphasizes equity in distribution. In most merger cases, equitable distribution approves mergers that improve (or do not degrade) consumer welfare. In unusual cases where buyer power (in the form of monopsony) is an important element, the welfare of input providers is also an important component of equitable distribution. Illegitimate profit which comes from exercise of anti-competitive market power should not be counted as a gain for social welfare under the antitrust laws. When there is monopoly power, the exploited consumer should be favored over the exploiting producer. In the case of monopsony power, antitrust law should favor the exploited producer over the exploiting consumer. Usually, but not always, the exploiting party will be a business firm that stands between producers and consumers.

Three Possible Economic Goals for Antitrust

Total wealth maximization: Society should maximize the total value of economic wealth, regardless of who gets that wealth. This goal is to maximize "total surplus," which is the sum of consumer surplus and producer surplus. Total surplus is also sometimes called "social surplus" or "efficiency" by its advocates. These latter terms are inappropriate, because they imply some non-existent economic or social consensus that wealth maximization is the proper social and economic objective. This goal is advocated by Bork, Posner, and most economists.

Consumer wealth maximization: Society should maximize "consumer surplus." This means maximizing the value to consumers *in each market*, subject to the constraint that producers are willing to produce. The phrase "in each market" is necessary to distinguish consumer wealth from total wealth, since all producers are also consumers. It should be noted that some advocates of total wealth maximization claim, somewhat confusingly, that their goal is to maximize consumer welfare. This goal is advocated by Lande, most attorneys, and possibly the courts (See Kirkwood).

Producers receive their value marginal product (VMP): Society should give each producer his or its VMP. For individuals, the VMP of labor is determined by the answer to this question: If this individual did not exist, or did not contribute his labor, by how much would the total value of economic output decline? For a piece of land or capital, a similar calculation of VMP can be made. This equity goal was advocated in the latter part of the nineteenth century by a number of economists (See Clark and George). Their views on economic equity influenced and reflected public opinion and likely influenced Congress, at least to some extent.

Discussion of the Three Possible Economic Objectives

As is widely known, total wealth maximization requires maximizing the sum of consumer surplus and producer surplus. Consumer wealth maximization requires maximizing only consumer surplus. These two goals may conflict in some antitrust situations. The validity of these two goals and their relationship with the VMP equity criterion is explored below.

Critique of Consumer Wealth Maximization. If the typical antitrust situation is one in which producers have market power, the antitrust laws will typically aid the consumers, not producers. If the typical recipient of monopoly profit is a business firm, the antitrust laws will typically limit business structure or conduct. Thus, it may appear that the antitrust laws are pro-consumer. It does not follow that the purpose is to maximize consumer surplus.

We can ask if consumer surplus maximization corresponds with an antitrust goal or other social goal for competitive markets. If the goal in all markets were simply to maximize consumer surplus, then all competitive markets should be regulated (where feasible) to reduce consumer prices below the competitive level. Since not all producers are willing to produce at below-competitive prices, the smaller total quantity that results from a price ceiling must be rationed among consumers. An example is rent control. An example in the opposite direction is an agricultural price support (price floor), which is intended to increase producer surplus and which works by rationing the number of producers who are allowed to participate.

Although there is some evidence that government seeks to maximize consumer surplus in some markets, there is also evidence that government seeks to maximize producer surplus in other markets. Most markets do not appear to be regulated to maximize either consumer surplus alone or producer surplus alone, nor is it the competitive ideal. Hence, we should reject an extreme consumer welfare objective for antitrust on logical grounds, since it is not fully consistent with the competitive ideal. However, a less extreme consumer welfare objective, for most antitrust circumstances, is consistent with the VMP equity criterion,

This still leaves total wealth maximization and the VMP equity criterion as possible objectives for antitrust. Both objectives are consistent with the ideals of antitrust for both competitive markets and monopoly markets. Which is better?

Description of VMP Equity Goal. The implications of payment according to VMP are less well known. Payment according to VMP requires measuring the VMP of each factor of production (e.g., capital or labor) and then paying each factor in proportion to VMP. Competitive markets tend to do this automatically. In an unregulated monopoly market, factors tend to be paid according to their Marginal Revenue Product (MRP), except for the monopoly owner(s) who receive an excess profit. Typically, MRP < VMP, so each factor is paid proportionately less than VMP, except for the monopoly owner.

In a regulated monopoly market, the best that can be hoped for (in the absence of subsidy) is that prices be set equal to long-run average costs, so that the monopoly owner receives no excess profit. If the industry is a natural monopoly or oligopoly with marginal cost (MC) less than average cost (AC), and if no subsidy is allowed, then factors cannot be paid the full value of their VMP. Instead, factors of production can be paid the Value of their Average Products (VAP). When MC < AC, then VAP < VMP.

With the VMP equity criterion, excess profits are seen as wrong when they correspond to no production that justifies their receipt. Excess profits are an overpayment to the monopoly owner, who may be most closely associated with labor, land, or capital, depending on how the industry is organized.

Critique of Total Wealth Maximization. The VMP equity criterion is more concerned with the equitable distribution of wealth than with maximizing the total amount of wealth. This contrasts sharply with the total wealth maximizing goal, which is not concerned with the fairness of wealth distribution. Or to put it another way, total wealth maximization simply assumes that whatever rules maximize total wealth must be fair. There is no independent standard of fairness.

However, the VMP equity criterion is less forgiving of excess profits that are not justified by production. Such excess profits are viewed as "illegitimate" and not as worthy of social maximization as legitimate wealth. Hence, in the typical antitrust situation where producers have market power, the VMP equity criterion is more pro-consumer than the total wealth maximization criterion. In this sense, the VMP equity criterion is pro-consumer when sellers have market power, but pro-producer when buyers have market power.

To determine whether total wealth maximization or the VMP equity criterion is a better objective for antitrust, one should also look outside antitrust. Total wealth maximization does not care who gets the wealth, but VMP equity requires that producers obtain the value of what they produce. Thus, objection to slavery is a part of the VMP equity criterion. Total wealth maximization's objection to slavery is purely contingent, based on the unproven supposition that slavery is inefficient. Objection to thievery is also part of the VMP equity criterion. Total wealth maximization's objection to thievery is purely contingent, based on the supposition that property is more valuable to the owner or producer than to the taker or thief.

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